

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

UNITED STATES OF AMERICA,

No. C-07-4762 PJH (JCS)

Plaintiff,

**REPORT AND RECOMMENDATION RE
PLAINTIFF'S RENEWED MOTION FOR
DEFAULT JUDGMENT AS TO
DEFENDANT DERIVUM USA [Docket No.
400]**

v.

CHARLES CATHCART, ET AL,

Defendants.

I. INTRODUCTION

On December 17, 2007, Plaintiff filed a motion for default judgment as to Defendant Derivium Capital (USA), Inc., which was referred to the undersigned magistrate judge for a report and recommendation. Default against Derivium Capital (USA), Inc. ("Derivium USA") was entered by the Clerk's office on December 21, 2007. Docket No. 19. Subsequently, the owner of Derivium Capital (USA), Inc., Charles Cathcart ("Cathcart"), appeared in this action. Thereafter, Plaintiff agreed to withdraw the Motion without prejudice to refile it once Plaintiff's claims against Charles Cathcart had been determined in order to avoid the possibility of inconsistent outcomes. Docket No. 60. A trial on stipulated facts against Charles Cathcart was scheduled to begin on November 19, 2009. *See* Order dated November 23, 2009, Docket No. 399. The Court entered a stipulated permanent injunction against Charles Cathcart. *Id.* Derivium USA did not appear or otherwise defend the action.

Plaintiff now renews its motion for Default Judgment ("the Motion") against Defendant Derivium USA. Docket No. 400. The matter was again referred to the undersigned for a report and recommendation. Docket No. 401. A hearing was held on February 12, 2010, at which Plaintiff appeared by telephone. Defendant did not appear. For the reasons set forth more fully below, the

1 Court recommends that the Motion for Default Judgment as to Defendant Derivium USA be
2 GRANTED and a permanent injunction be entered.¹

3 **II. ANALYSIS**

4 **A. Background**

5 The present action was filed by the Plaintiff United States of America in 2007 alleging that
6 Defendants are subject to penalty under Internal Revenue Code (“I.R.C.”) 26 U.S.C. §§ 6700 and
7 6701, and seeking an injunction pursuant to §§ 7402 and 7408 against, among others, Robert Nagy
8 and co-defendants Charles Cathcart and Derivium USA² based upon their participation in a 90%
9 stock loan program. Plaintiff sought to enjoin Defendants from: (1) organizing, promoting,
10 marketing, or selling any tax shelter plan, or any other arrangement that advises or encourages others
11 to attempt to violate the internal revenue laws or unlawfully evade the assessment or collection of
12 their federal tax liabilities; (2) engaging in conduct subject to penalty under § 6700, *i.e.*, making or
13 furnishing, in connection with the organization or sale of a shelter, plan, or other arrangement, a
14 gross valuation or overstatement or a statement about securing any tax benefits that they know or
15 have reason to know is false or fraudulent as to any material tax matter; and (3) engaging in any
16 other conduct that interferes with the administration and enforcement of the internal revenue laws.
17 Plaintiff has sought only injunctive relief against Derivium USA.

18 **B. The Stipulated Permanent Injunction Against Charles Cathcart**

19 On the morning of trial, November 19, 2009, Defendant Charles Cathcart, informed the
20 district court that he would not contest the factual allegations against him. As a result, the district
21 court entered an order, based upon stipulated facts, finding that Cathcart had engaged in conduct
22 covered by 26 U.S.C. § 6700, and ordered an injunction under I.R.C. § 7408 to prevent him from
23 engaging in such further conduct. The court found that, under I.R.C. § 7402(a), injunctive relief
24 against Cathcart was “necessary or appropriate for the enforcement of the Internal Revenue laws.”
25 Pursuant to I.R.C. § 7402(a) and 7408, the court entered the following injunction against
26

27 ¹Derivium USA is the only remaining defendant to this action. The case has been resolved
28 against every other defendant in the case. *See* Docket Nos. 9, 17, 129, 318, 319, 320, 325, 382, 399.

²Derivium Capital was formerly a defendant in this action, but has since agreed to a permanent
injunction. Derivium Capital was a predecessor of Derivium USA.

Defendant Cathcart, preventing him from, directly or indirectly, by use of any means or instrumentalities:

1. Organizing, promoting, marketing, selling, or implementing the “90% Loan” program that is the subject of the complaint herein;

2. Organizing, promoting, marketing, selling, or implementing any program, plan or arrangement similar to the 90% Loan program that purports to enable customers to receive valuable consideration in exchange for stocks and other securities that are transferred or pledged by those customers, without the need to pay tax on any gains because the transaction is characterized as a loan rather than a sale;

3. Engaging in any conduct subject to penalty under I.R.C. § 6700, *i.e.*, by making or furnishing, in connection with the organization or sale of a plan or arrangement, a gross valuation overstatement or a statement Cathcart knows or has reason to know to be false or fraudulent as to any material matter under the federal tax laws; and

4. Selling or organizing, or causing the sale or organization, of any type of corporation, trust, limited liability company, arrangement of business entities, or plan which he knows or has reason to know advocates or facilitates material non-compliance with the federal tax laws.

In addition, the district court ordered that he United States may conduct post-judgment discovery to monitor compliance with the injunction, and also retained jurisdiction over the action for the purposes of implementing and enforcing the final judgment and any additional orders necessary and appropriate to the public interest.

C. Jurisdiction

When a plaintiff seeks entry of default judgment against a defendant who has failed to appear or otherwise defend the action, the court has an affirmative duty to determine whether it has jurisdiction over both the claims and the parties. *In re Tuli*, 172 F.3d 707, 712 (9th Cir. 1999). The Court will therefore assess whether it has subject matter jurisdiction over this action and whether personal jurisdiction over the Defendant Derivium USA exists.

1. Subject Matter Jurisdiction

District courts have original jurisdiction over civil cases arising under the

1 Constitution, laws or treaties of the United States. 28 U.S.C. § 1331. As stated in greater detail
2 above, Plaintiff the United States of America has asserted claims against Defendant Derivium USA
3 to enjoin him for alleged violations of the federal tax laws. The district court may therefore properly
4 exercise jurisdiction over this matter.

5 **2. Personal Jurisdiction**

6 In the present case, Plaintiff contends that the district court has specific personal
7 jurisdiction over the defendants. Defendant Derivium USA is a Delaware corporation registered to
8 do business in the State of South Carolina. Compl. ¶ 13. Plaintiff alleges that Defendant directed its
9 activities to the forum state, California, by marketing the 90% Loan scheme to customers located in
10 this district. Motion at 4 (Docket 400), *citing Yahoo! Inc. v. La Ligue Contre Le Racisme Et*
11 *L'Antisemitisme*, 433 F.3d 1199, 1205-07 (9th Cir. 2006) (discussing standards for personal
12 jurisdiction). In addition, Plaintiff alleges that Derivium USA had staff based in San Francisco
13 during its period of active promotion of the 90% Loan scheme. Motion at 2 citing Second Amended
14 Complaint at ¶¶ 2, 28.

15 Because Defendant had an office and staff in San Francisco and marketed its products to
16 California residents, there is sufficient evidence of systematic and continuous contacts with this
17 forum, as well as sufficient evidence of purposeful availment, for the Court to find that there is both
18 specific and general personal jurisdiction over Defendant Derivium USA in California. *See e.g.*,
19 *Perkins v. Benguet Consolidated Mining Co.*, 342 U.S. 437, 447-49 (1952) (upholding finding of
20 general jurisdiction where the president of a Philippines-based corporation maintained an office in
21 the forum state, had bank accounts in the forum state, and held several directors' meetings in the
22 forum state).

23 Moreover, the Court finds that exercising personal jurisdiction over Defendant Derivium
24 USA would be reasonable. Derivium USA purposefully availed itself of the privilege of doing
25 business in California through its substantial, continuous, and systematic contacts with California.
26 Due to its ties with California, including the presence of an office and staff here, the Court concludes
27 that Derivium USA had fair warning that it could be haled into court in California. Accordingly,
28 asserting jurisdiction over Derivium USA is reasonable and does not offend "traditional notions of

1 fair play and substantial justice.” *Int’l Shoe Co. v. State of Washington*, 326 U.S. 310, 316 (1945).

2 **D. Legal Standard Applicable to Default Judgment Motions**

3 Pursuant to Rule 55(b)(2) of the Federal Rules of Civil Procedure, the court may enter a
4 default judgment where the clerk, under Rule 55(a), has previously entered the party’s default based
5 upon failure to plead or otherwise defend the action. Fed. R. Civ. P. 55(b). A defendant’s default,
6 however, does not automatically entitle the plaintiff to a court-ordered default judgment. *Draper v.*
7 *Coombs*, 792 F.2d 915, 924-25 (9th Cir. 1986). The district court has discretion in its decision to
8 grant or deny relief upon an application for default judgment. *Aldabe v. Aldabe*, 616 F.2d 1089,
9 1092 (9th Cir. 1980); *Lau Ah Yew v. Dulles*, 236 F.2d 415, 416 (9th Cir. 1956) (affirming district
10 court’s denial of default judgment). The Court may consider the following factors in deciding
11 whether to enter a default judgment:

12 (1) the possibility of prejudice to the plaintiff, (2) the merits of
13 plaintiff’s substantive claim, (3) the sufficiency of the complaint, (4)
14 the sum of money at stake in the action; (5) the possibility of a dispute
15 concerning material facts; (6) whether the default was due to
excusable neglect, and (7) the strong policy underlying the Federal
Rules of Civil Procedure favoring decisions on the merits.

16 *Eitel v. McCool*, 782 F.2d 1470, 1471-72 (9th Cir. 1986).

17 In considering the sufficiency of the complaint and the merits of the plaintiff’s substantive
18 claims, facts alleged in the complaint not relating to damages are deemed to be true upon default.
19 *Geddes v. United Fin. Group*, 559 F.2d 557, 560 (9th Cir. 1977); Fed. R. Civ. P. 8(d). On the other
20 hand, a defendant is not held to admit facts that are not well-pleaded or to admit conclusions of law.
21 *Nishimatsu Constr. Co. v. Houston Nat’l Bank*, 515 F.2d 1200, 1206 (5th Cir. 1975). As a result,
22 where the allegations in a complaint are not “well-pleaded,” liability is not established by virtue of
23 the defendant’s default and default judgment should not be entered. *Id.*

24 **E. Analysis of *Eitel* Factors**

25 **1. Possible Prejudice to Plaintiff**

26 Plaintiff would suffer prejudice if default judgment is not entered because Plaintiff would be
27 without another course of recovery. Denying a plaintiff a means of recourse is by itself sufficient to
28 meet the burden posed by this factor. *See e.g., Phillip Morris, USA, Inc. v. Castworld Prods., Inc.*,

1 219 F.R.D. 494, 499 (C.D. Cal. 2003). Moreover, the allegations in this case, accepted as true on
2 default, demonstrate that Defendant Charles Cathcart frequently changed the names of the entities or
3 created new entities through which to conduct the loan scheme. Second Amended Compl. at ¶¶ 20,
4 22-24. Derivium USA was created in order to take over the marketing of the 90% Loan Program.
5 *Id.* at ¶¶ 33-34. Therefore, Plaintiff would be prejudiced by not having an injunction against
6 Derivium USA, similar to that ordered by the district court as to Defendant Cathcart. Without it,
7 Derivium USA could continue with the unlawful scheme.

8 **2. Sufficiency of the Complaint and Substantive Merits of Claim**

9 Plaintiff alleges that Charles Cathcart created Derivium USA to take over the responsibility
10 of marketing the 90% Loan program. Second Amended Compl. at ¶¶33-34. Charles Cathcart is the
11 sole owner of Derivium USA. *Id.* ¶ 11. Derivium USA promoted “the 90% Stock Loan” and other
12 products to people who held appreciated securities with a relatively low basis, promising that the
13 transactions would allow customers to “monetize” their securities without paying taxes on their
14 capital gains. *Id.* ¶¶ 49-52. The Complaint alleges that Derivium USA made numerous false or
15 fraudulent statements to prospective customers with respect to the tax benefits of the 90% Loan
16 program (*id.* at ¶¶ 76-82), including the statement that the transactions were not taxable because they
17 are genuine loans. *Id.* ¶77. The evidence at the trial of this matter against Cathcart provides further
18 support for Plaintiff’s allegations against Cathcart’s company, Derivium USA.³ As the district court
19 found previously in this case, the Loan transactions were simply sales of securities disguised as
20 loans in order to avoid taxes. *Id.* ¶54, 82; *see also* Order dated September 22, 2009, Docket 333
21 (order granting summary judgment to the plaintiff on the loan-versus-sale issue). Derivium USA
22 has failed to respond in any way to the lawsuit, and has not presented any defense, meritorious or
23 otherwise. For the reasons stated more fully below, the Court finds that this factor weighs in favor
24 of granting the motion for default judgment and entering an injunction identical to that ordered as to
25 Defendant Charles Cathcart, Derivium’s sole owner.

27 ³At the trial, Defendant Cathcart stipulated to the majority of the United States’ allegations
28 against him. *See* Docket No. 398, 1a & d (Minute entry reflecting Cathcart’s stipulation to the majority
of the United States’ proposed findings of fact).

1 a. *IRC §§ 6700 and 7408*

2 Section 7408 authorizes a court to enjoin persons who have engaged in any conduct subject
3 to penalty under § 6700 if the court finds that injunctive relief is appropriate to prevent the
4 recurrence of such conduct. 26 U.S.C. § 7408. Section 6700 penalizes anyone who organizes or
5 assists in the organization of:

6 a partnership or other entity, any investment plan or arrangement, or any other plan or
7 arrangement, or participates directly or indirectly in the sale of any interest in an entity or
8 plan or arrangement, . . . and makes or furnishes or causes another person to make or furnish
9 (in connection with such organization or sale) a statement with respect to the allowability of
10 any deduction or credit, the excludability of any income, or the securing of any other tax
11 benefit by reason of holding an interest in the entity or participating in the plan or
12 arrangement which the person knows or has reason to know is false or fraudulent as to any
13 material matter, or a gross valuation overstatement as to any material matter.

14 26 U.S.C. § 6700.

15 To establish a violation of § 6700 warranting an injunction under § 7408, the government
16 must prove that defendant: (1) organized or sold, or participated in the organization or sale of, an
17 entity, plan, or arrangement; (2) made or caused to be made, false or fraudulent statements
18 concerning the tax benefits to be derived from the entity, plan, or arrangement; (3) knew or had
19 reason to know that the statements were false or fraudulent; (4) the false or fraudulent statements
20 pertained to a material matter; and (5) an injunction is necessary to prevent recurrence of this
21 conduct. *United States v. Estate Preservation Servs.*, 202 F.3d 1093, 1098 (9th Cir. 2000) citing
22 I.R.C. §§ 6700(a), 7408(b). “Under § 6700, any ‘plan or arrangement’ having some connection to
23 taxes can serve as a ‘tax shelter’ and will be an ‘abusive’ tax shelter if the defendant makes the
24 requisite false or fraudulent statements concerning the tax benefits of participation.” *United States*
25 *v. Raymond*, 228 F.3d 804, 811 (7th Cir. 2000). “Congress designed section 6700 as a ‘penalty
26 provision specifically directed toward promoters of abusive tax shelters *and other abusive tax*
27 *avoidance schemes.*’ ” *United States v. White*, 769 F.2d 511, 515 (8th Cir. 1985) (emphasis in
28 original). The district court has previously found in this case that the Plaintiff need not specifically
prove that Defendants were involved in an abusive tax shelter to establish a violation of § 6700
warranting an injunction under § 7408. Rather, the district court concluded that Plaintiff must only
prove the five elements set forth by the Ninth Circuit in *Estate Preservation Servs.*, 202 F.3d at

1 1098. Section 6700 is directed not only toward promoters of abusive tax shelters, but also toward
2 other abusive tax avoidance schemes. *Id.*

3 Under § 7408, conduct may be enjoined if the court finds: 1) that the person has engaged in
4 any conduct subject to penalty under section 6700 (relating to penalty for promoting abusive tax
5 shelters, etc.) or section 6701 (relating to penalties for aiding and abetting under-statement of tax
6 liability), and (2) that injunctive relief is appropriate to prevent recurrence of such conduct. 26
7 U.S.C. § 7408(a).

8 In an order dated September 22, 2009, the district court granted in part and denied in part,
9 Defendants' motions for summary judgment. The court found that the undisputed evidence revealed
10 that⁴: as part of the loan transaction in question, legal title of a customer's securities transfers to
11 Derivium USA (for example) during the purported loan term in question, which vests possession of
12 the shares in Derivium's hands for the duration of the purported loan term; that the customer must
13 transfer 100% of all shares of securities to Derivium USA and that once transferred, Derivium USA
14 sells those shares on the open market, and that once sold, Derivium USA transfers 90% of that sale
15 amount to the customer as the "loan" amount, keeping 10% in Derivium USA's hands; that during
16 the term of the loan, the Master Loan Agreement provides that Derivium USA has the right to
17 receive all benefits that come from disposition of the customer's securities, and that the customer is
18 not entitled to these benefits; that the customer is furthermore prohibited from repaying the loan
19 amount prior to maturity and is not required to pay any interest before the loan maturity date; and
20 that, at the end of the purported loan term, the customer is not required to repay the amount of the
21 loan (but merely allowed to do so as one option at the loan's maturity date) and can exercise the
22 option to walk away from the loan entirely at the maturity date without repaying the principle; and
23 thus, can conceivably walk away from the transaction without paying interest at all on the loan.

24 The district court concluded that analysis of these and other undisputed facts pursuant to
25 either the benefits/burdens approach outlined in *Grodt & McKay Realty, Inc. v. Commissioner of*
26 *Internal Revenue*, 77 T.C. 1221, 1236 (Tax Court 1981), or the approach outlined in *Welch v.*

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28 ⁴The following factual findings are taken directly from Judge Hamilton's Order dated September
22, 2009. Docket No. 333.

1 *Comm'r*, 204 F.3d 1228, 1230 (9th Cir. 2000), compelled the conclusion that the transactions in
2 question constituted sales of securities, rather than bona fide loan transactions. *See e.g., Grodt*, 77
3 T.C at 1236-37 (applying multi-factor test to determine point at which the burdens and benefits of
4 ownership are transferred for purposes of qualifying a transaction as a sale); *Welch*, 204 F.3d at
5 1230 (examining factors necessary to determine whether a transaction constitutes a bona fide loan).

6 The district court also found that the “substance over form doctrine” further supported the
7 conclusion that, in looking beyond the actual language of the Master Loan Agreement to the totality
8 of the undisputed facts, the substance of the transaction between the parties constituted a sale, and
9 not a bona fide loan. *See, e.g., Harbor Bancorp & Subsidiaries v. Comm'r*, 115 F.3d 722, 729 (9th
10 Cir. 1997) (it is axiomatic that tax law follows substance and not form).

11 The district court therefore granted the government’s motion for partial summary judgment
12 on the issue whether the 90% loan transactions in question constituted sales of securities, as a matter
13 of law. The element of scienter was the primary issue left to the finder of fact. A trial was held on
14 November 19, 2009, at which Defendant Cathcart appeared and did not contest the majority of the
15 factual allegations against him. The court held a trial on stipulated facts and entered a permanent
16 injunction against him.

17 Reviewing the above evidence and legal authorities cited above, the Court concludes that the
18 evidence against Defendant Derivium USA is strong and that the merits of the case support entry of
19 default judgment here. The Court concludes that an injunction against Derivium is necessary or
20 appropriate for the enforcement of the internal revenue laws. *See e.g., United States v. Thompson*,
21 395 F.Supp.2d 941, 945-46 (E.D. Cal., 2005) (“Injunctive relief is appropriate if the defendant is
22 reasonably likely to violate the federal tax laws again.”)

23 **3. The Sum of Money at Stake**

24 In the Complaint, the United States seeks only equitable relief. Therefore, the Court finds
25 that the fourth *Eitel* factor’s concern with awarding large sums of money without an adjudication on
26 the merits does not alter the analysis above. This factor supports entry of default judgment. *See*
27 *e.g., Levi Strauss & Co. v. Toyo Enterprise Co.*, 2009 WL 3353097 at *10 (N.D. Cal. 2009).

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1 **4. Possibility of Dispute Concerning Material Facts**

2 The fifth *Eitel* factor examines the likelihood of dispute concerning the material factors
3 surrounding the case. As detailed above, Plaintiff has sufficiently alleged and has submitted exhibits
4 demonstrating Defendant's violations of the tax laws. In addition, Derivium USA's sole owner,
5 Charles Cathcart, stipulated to the majority of the factual allegations against him at his trial. It is
6 therefore unlikely that Defendant would be able to present facts raising any dispute as to these
7 allegations. Accordingly, this factor favors entry of default judgment.

8 **5. Excusable Neglect**

9 There is no indication that Derivium USA's failure to answer or appear was the result of
10 excusable neglect. The Complaint in this action was served on Derivium USA on October 10,
11 2007.⁵ Docket No. 15 (proof of service). There has been no attempt on Derivium USA's part to
12 respond to Plaintiff's allegations. Therefore, the Court concludes that Defendant's failure to respond
13 was not due to excusable neglect.

14 **6. Policy for Deciding on the Merits**

15 The last *Eitel* factor examines whether the strong policy favoring deciding cases on the
16 merits prevents a court from entering default judgment. Default judgments are disfavored, and cases
17 should be decided on the merits when possible. *Pena v. Seguros La Comercial, S.A.*, 770 F.2d 811,
18 814 (9th Cir. 1985). Where, as here, a Defendant's failure to appear "makes a decision on the merits
19 impractical, if not impossible," entry of default judgment is warranted. *Pepsico, Inc. v. Cal. Sec.*
20 *Cans*, 238 F.Supp.2d 1172, 1177 (C.D.Cal.2002). Despite Defendant Cathcart's decision to litigate
21 this case for years, his company, Derivium USA, has not defended against the action. Derivium
22 USA has had ample notice of the suit and many opportunities to appear. On this record, it is clear to
23 the Court that given that Defendant Derivium USA has failed to appear or respond in this matter, a
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25 ⁵After entry of default, the United States amended its complaint on two occasions to add
26 defendants and plead more facts concerning those defendants. Docket Nos. 57 & 124. Because the
27 amended complaints did not add new claims against Derivium USA and because Derivium USA was
28 in default, service of the subsequent complaints was not required under the Federal Rules of Civil
Procedure. Fed.R.Civ.P. 5(a)(2); *Employee Painters' Trust v. Ethan Enterprises, Inc.*, 480 F.3d 993,
999 & n.6 (9th Cir. 2007)

1 decision on the merits is impossible. This final factor favors entry of default judgment as well.

2 **III. CONCLUSION**

3 For the foregoing reasons, the Court recommends that Plaintiff's Motion for Default
4 Judgment be GRANTED. The Court recommends that the district court find that:

- 5 A. Derivium USA has engaged in conduct covered by 26 U.S.C. § 6700, and that injunctive
6 relief is appropriate under I.R.C. § 7408 to prevent it from engaging in such further conduct;
7 and
8 B. under I.R.C. § 7402(a), injunctive relief against Derivium is "necessary or appropriate for the
9 enforcement of the Internal Revenue laws."

10 In addition, the Court recommends that the district court enter the following injunction:

- 11 A. Pursuant to I.R.C. § § 7402(a) and 7408, Derivium USA is enjoined and restrained from,
12 directly or indirectly, by use of any means or instrumentalities:
- 13 1. Organizing, promoting, marketing, selling, or implementing the "90% Loan"
14 program that is the subject of the complaint herein;
 - 15 2. Organizing, promoting, marketing, selling, or implementing any program, plan or
16 arrangement similar to the 90% Loan program that purports to enable customers to receive
17 valuable consideration in exchange for stocks and other securities that are transferred or
18 pledged by those customers, without the need to pay tax on any gains because the transaction
19 is characterized as a loan rather than a sale;
 - 20 3. Engaging in any conduct subject to penalty under I.R.C. § 6700, *i.e.*, by making or
21 furnishing, in connection with the organization or sale of a plan or arrangement, a gross
22 valuation overstatement or a statement Derivium USA knows or has reason to know to be
23 false or fraudulent as to any material matter under the federal tax laws; and
 - 24 4. Selling or organizing, or causing the sale or organization, of any type of
25 corporation, trust, limited liability company, arrangement of business entities, or plan which
26 he knows or has reason to know advocates or facilitates material non-compliance with the
27 federal tax laws.

28 Finally, the Court recommends that the United States be permitted to conduct post-judgment

1 discovery to monitor compliance with the injunction and retain jurisdiction over this action for the
2 purposes of implementing and enforcing the final judgment and any additional orders
3 necessary and appropriate to the public interest.

4 IT IS SO ORDERED.

5 Dated: February 12, 2010

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JOSEPH C. SPERO
United States Magistrate Judge